Mercantilism in a Liberal World Order: The Origins of Persistent Current Account Imbalances

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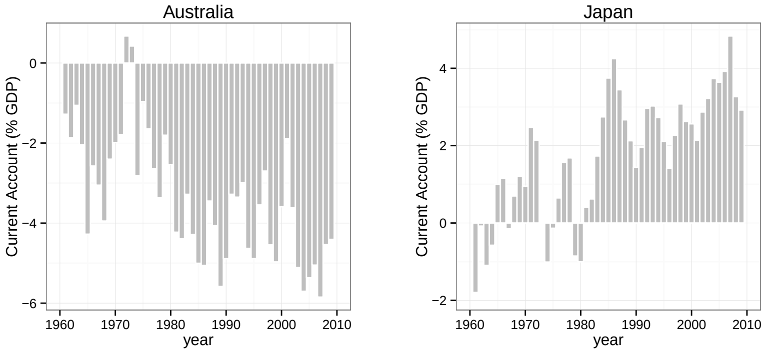
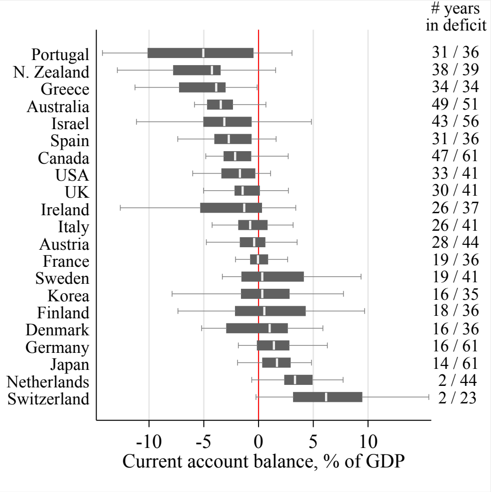
Motivation

- Current account imbalances promote financial instability
- Deficits/surpluses persist over decades
- Exchange rate adjustment works for many countries (France, Italy, etc)...
- But fails for the US, UK, Australia, Canada, China, Germany, Japan, Sweden, Denmark, Switzerland, New Zealand & others.

Two examples



The Big Picture



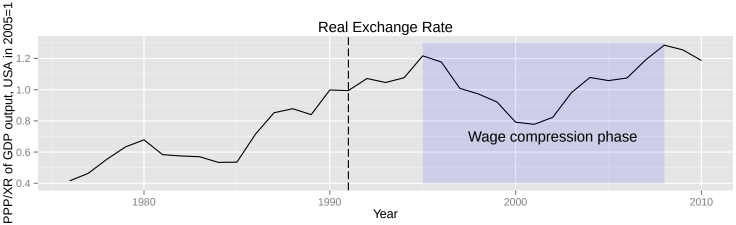
Question

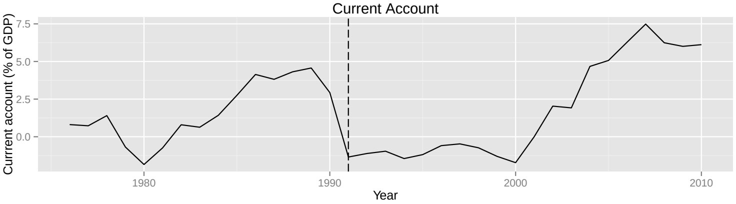
- Why do some countries persistently run current account surpluses and others persistently deficits?
- Why does adjustment via the real exchange rate fail to balance current accounts?

Stylized facts

- Some countries have centralized, coordinated wage bargaining (CWB) institutions, others decentralized wage setting institutions (cf. Varieties-of-Capitalism literature)
- CWB countries have high real exchange rates
- But their real exchange rates appreciate relatively slowly
- CWB countries "correct" quickly to long-term equilibrium after external shocks

Example Germany and Reunification as Exogenous Event





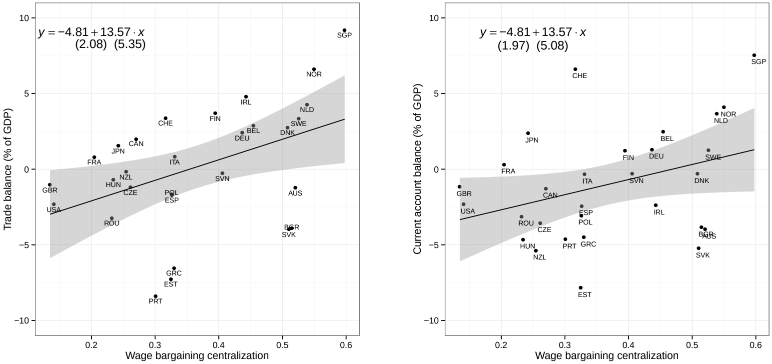
Institutional Equilibrium: The Upside

- Exporting firms have no pricing power in foreign markets
- CWB institutions can enforce industry-wide wage settlements
- Wage settlements do not exceed productivity gains
- Real exchange rates appreciate slowly
- Competitiveness is maintained and exports boom

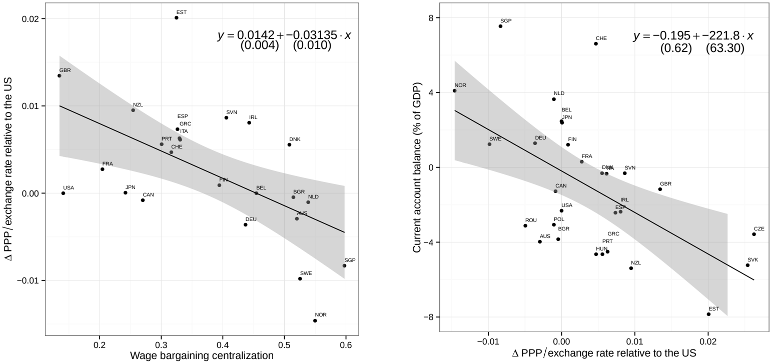
Institutional Equilibrium: The Downside

- Wage compression creates reverse Balassa-Samuelson effect
- This threatens to reduce wages in non-tradable sector
- So non-tradable sector responds by creating barriers to entry
- Tradable sector subsidizes wages in non-tradable sector
- Services sector remains protected, worsening trade imbalances

Wage bargaining centralization and trade and current account balances



Wage bargaining centralization, Δ real exchange rate, and the current account



Short-run ECM and long-run linear model: Variables

Dependent variable: Trade balance or current account balance in year t or five-year average, all relative to GDP

Independent variable: Wage bargaining centralization

Controls variables:

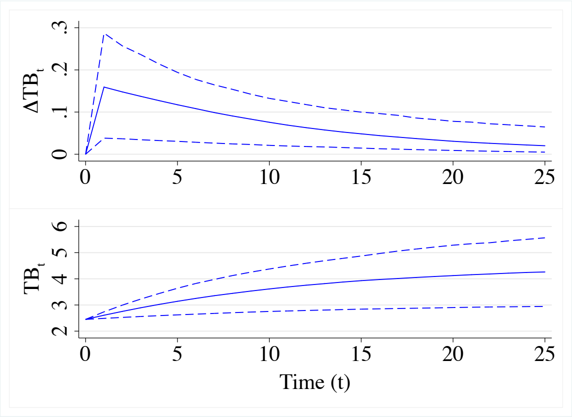
Real exchange rate (PPP/XR)
Labour compensation/GDP
Dependency ratio
Foreign reserve balance/GDP

Δ total factor productivity
Fuel exports share/GDP
Fiscal balance/GDP
Net foreign assets/GDP

Findings

- Lagged wage bargaining centralization score correctly signed, significant, substantively large in trade balance models
- Δ real exchange rate negatively affects external balances
- More fragile results for full current account model with lagged dependent variable ($\approx \Delta$ net foreign assets)
- Greater labour compensation share in GDP reduces surpluses
- Other control variables behave as expected

Simulation (ECM)



Long-term effect of a standard deviation increase in centralization; bootstrapped 95% confidence intervals.

Conclusion

- Centralized wage bargaining institutions permit wage compression (but perhaps only with closed service sector)
- Wage compression sustains current account surpluses
- Not a policy variable: hard to change in short run
- More promising: open service sector in CWB countries